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Purdue Institute for Family Business

Quarterly Newsletter

Winter 2021: Succession Planning Issue

Articles in this Newsletter:

Financial Contingency Planning and the Feasibility of Adding a Family Member to the Operation

Ed Farris, Nick Held, and Michael Langemeier

As a farm expands, it is important to evaluate the feasibility of adding an operator and/or hired employee to the operation. There are at least three factors that need to be considered when examining the feasibility of augmenting labor. First, is gross revenue large enough to pay for an additional person. Second, is the farm profitable enough to add an additional person to the operation. Third, will the farm be able to cover term debt payments and replace assets in a timely fashion after another person has been added to the operation. Each of these factors is discussed further below.

Let's start by discussing gross revenue. Most accrual income statements include a line for gross revenue. To compute gross revenue, we add crop and livestock sales to government payments, crop insurance indemnity payments, and miscellaneous income (e.g., patronage dividends; income from custom work) and subtract beginning crop and market livestock inventories from ending crop and market livestock inventories. The inventory adjustments ensure that income earned in a particular production year is reflected in net farm income for that production year. As a rule of thumb, it takes approximately $500,000 to support each full-time worker (operator; hired employee). This amount reflects the fact that we need to pay the additional person, and in most instances invest in additional assets (e.g., machinery and equipment, buildings, land) when we add an individual to the operation.

Profitability can be measured using the net farm income ratio, the operating profit margin ratio, return on assets, or return on equity. In this article, we will focus on the net farm income ratio, which is computed by dividing accrual net farm income by gross revenue. Accrual net farm income is computed by subtracting accrual expenses from gross revenue, and is used to cover family living withdrawals, income and social security taxes, principal payments on term debt, and to purchase assets such as machinery and equipment. A commonly used benchmark for the net farm income ratio is 20 percent or higher. For most farms, this ratio was above this level from 2007 to 2013, and 2020, but below this level from 2014 to 2019. Thus, the 20 percent figure should be thought of as a long-term benchmark (e.g., tenyear measure). This is important to note because we want to make sure that the farm is profitable enough after adding an additional person in the long-run, not just in our best years.

Using a gross revenue of $500,000 per worker and a net farm income ratio of 20 percent, results in a net farm income target of $100,000 per worker. This amount would ensure that the farm has the funds to pay an additional operator or employee, and help purchase machinery and equipment and other assets needed to expand.

In addition to examining gross revenue and profitability, it is important to gauge whether the farm has enough cash flow to cover owner withdrawals, principal payments, and to replace worn-out or fully depreciated machinery, equipment, and buildings. In the long-run, net farm income plus depreciation has to be large enough to cover owner withdrawals, principal payments, replace depreciable assets, and purchase new and used capital assets. A loss in working capital and net worth will result if the business earnings do not cover these items in the long run.

Where does contingency planning come in? Contingency planning helps a business respond to cash flow shortages resulting from low yields, or low crop or livestock prices. The computations discussed above represented long-run averages. Consider the following questions. Where would we obtain the funds or what adjustments would need to be made with respect to owner withdrawals if net farm income is relatively low or even negative? How would we cover term debt payments in a low-income year? How large does net cash flow need to be for the farm to be comfortable with replacing and purchasing assets? Contingency planning does not make the problems associated with a low-income year disappear, but it does provide a plan as to how the farm could respond to a low-income year.

This article briefly discussed key factors to consider when adding an operator or hired employee to the operation. More information pertaining to financial management and contingency planning can be found on the web site for the Center for Commercial Agriculture (here).

Do You Have a Plan for Your Assets? (If Not, Indiana Has a Plan for Them)

Denise Schroeder and Thomas A. Appel, P.C.

Has your business selected the right business structure to hold, protect, and transfer assets? If you don't have a plan to transfer your assets – that is a plan! Indiana has a plan for you if you don't make a will, and most people won't want the plan Indiana has for them. For example – If you have a spouse and children, your spouse gets half of your estate and your children divide the other half equally. On the other hand, if the living spouse is a second spouse (not unrealistic since almost half of all marriages end in divorce) and there are children living from a prior marriage, then the surviving spouse receives fair market value of real property of deceased spouse minus the value of liens and encumbrances. So, if you truly want to have your assets transferred to your survivors the way you want – you must create a plan! As you create it, be sure to answer the what, why, who, when, and how of the plan.

The "What and Why" of the Plan

- What needs to be transferred?
    - *Land, equipment, agreements, partnership interest, stock, membership interests*
- What is the current ownership structure of the various assets?
- What is the tax basis in the assets?

- What is driving the need for a succession plan?
    - *Age of owners, retirement, death of a principal operation member, sickness*
- Is there a real desire to pass on and continue the farm operation on both sides?
- What are the primary goals?
    - *Continuation of the farm, tax avoidance, equal treatment of children, family unity, step-up in basis on farmland, empowering involved children or descendants to continue operating, cash flow for owners in retirement*

The "Who" of the Plan

You really should consider involving the "who" when you develop the plan. Get their input so you know their thoughts and ideas.

- Who are the players – the recipients of the transfer of various assets?
- Who will step into management roles?
- Are they capable of executing your plan?
- Is continuing with the farm the choice of the successors?
- Skills, education, abilities – are they qualified to operate the operation?
- Are they financially invested in the operations?
    - *Do off-farm heirs understand how this plan impacts them?*
    - *Have you considered options for heirs who aren't interested in owning farm ground or being part of the operation?*
- Do they have sweat equity invested?
- Are they a successor because they are a family member or because they are qualified?
- Is it a realistic expectation that successors have the skills to operate and grow the operation?
- Don't burden a successor with an unproductive or unskilled family member.

The "When" of the Plan

- When does the plan need to be put in place?
    - *Are you moving towards transferring the operation as you retire or are you planning on keeping control until you die?*
    - *If you are moving towards transferring the operation, have you considered the tax implications for both sides of the operation?*
- Consider the implications of delaying making a decision. Remember not making a decision is a decision!

The "How" of the Plan

- Identify the primary goals of the plan – what do you want to accomplish?
    - *Protecting assets from creditors of children and divorcing spouses*
    - *Succession plan for continuation of business, leadership of company*
    - *Tax considerations – limit the tax liability*
    - *Family issues – this is probably the most challenging and you need to be brutally honest with yourself when you consider this issue.*
- Identify the tools which you can use to accomplish those goals
- Trusts, life insurance, special needs trust, business structures, etc.

This is not usually something that happens quickly, but as you think through what you want to have happen with your assets consider the "who, what, where, when, why and how". Think about your goals for your assets and how you want to have this carried out. Discuss your wishes with your family and your advisory team (attorney, financial planner, etc.) and ensure they understand why you are developing a plan. **Lastly, remember, if you don't have a plan, Indiana has one for you!**

Conflict Management and Resolution in the Family Business

Linda Curley, Renee Wiatt and Maria I. Marshall

While conflict can be an everyday occurrence within a work environment, have you ever thought about effective ways to manage conflict in your business? What tools do you use to reduce or avoid conflict in order to get the job done? What strategies do you use to find a resolution that honors the concerns of all parties and optimizes the resources of all those involved? What is the true cost of conflict?

Conflict can have a very high cost to families and to businesses. In the United States, roughly 2.8 hours of productivity are lost per week per employee due to conflict (CPP Inc.). Furthermore, half of employers have been sued by emloyees and a quarter of U.S. employees have been sick or called in sick due to conflict. According to the Thomas-Kilmann Conflict Mode Instrument (TKI), there are 3 levels of conflict within the work environment; an organizational level, a group level, and an individual level. Kilmann also recognizes 5 predominant styles of conflict management. We often compete, collaborate, compromise, avoid, or accommodate when addressing conflict in our lives.

The first, competing, is often used when a quick decision is needed. A few examples might include cutting costs, enforcing unpopular rules, using disciplinary action, or addressing issues vital to the company's welfare. On the other hand, a business might use a collaborative method to find an integrative solution when the concerns of the parties involved are too important to compromise. The use of the compromising style is often applied when resolving issues of moderate importance. Perhaps, creating a temporary solution when dealing with time constraints, or reaching a resolution with equal power and strong commitment from all parties involved. Businesses often avoid conflict by putting off decision making when an unimportant issue can be left alone or addressed at a later date. Finally, the use of the accommodating style is applied to conflicting issues that can create goodwill, preserve harmony, or avoid disruption within the business or family.

Finding a resolution can take some work on the part of all parties involved. It's best to shift one's focus on the problem instead of placing blame on the opposing party. It's also important to focus on feelings by using an XYZ Formula. "When you do (X) in a situation (Y), I feel (Z)". An example, "When you neglect to answer my calls after leaving a message about our work agreement, I feel like our partnership isn't important to you".

It's important to remember that effective conflict management and resolution is vital in every aspect of one's business. Quickly solving problems can reduce costs and improve customer service. Effective communication is key. While there are a number of effective communication skills that can be used, remember to: listen to the content of the concern but also take notice of the underlying feelings or emotions that are expressed, validate concerns and feelings, and end conversations with explicit positive regard.

Finally, remember that you can stop small problems before they get out of hand. Reflect on the following:

- *How big is the problem?*
- *Who does this impact?*
- *How can we fix this?*

Practice using different conflict modes within your own environment so that you can become more aware of your own conflict style. Recognize styles most used by others, and carefully assess conflict situations as they arise. Be proactive to solve small problems before they become much bigger and begin to affect business costs and customer service satisfaction.

Contingency Planning for Your Farm Business

Renee Wiatt and Maria Marshall

Farms and agribusinesses are not immune to a variety of shocks and business disruptions that can occur. In fact, it could be argued that farms and agribusinesses are more vulnerable than many other small businesses. If you and or your spouse were to develop a life-threatening illness tomorrow, would your farm business be at risk of collapsing? What would happen if your most valuable employee were to walk off the job? What if you can't come to an agreement with your son/daughter who is interested in taking over the farm? These situations illustrate some of the "people risks" or "human resource risks" inherent in farming.

Farms and agribusinesses can be impacted by production, marketing, financial, legal, and human resource risks (Marshall and Alexander, 2005). It is likely that any operational farm has experienced a business disruption in the form of the recent pandemic (COVID-19), a recession, a market downturn, a natural disaster, or even effects of climate change. However, little is known about how farms are managed through the recovery process.

Farms are specifically vulnerable to weather-related and human resource risks. However, human resource risk can be minimized or avoided with proper planning. Human resource risk can stem from poor communication in your family and your business as well as poor people management practices. Other risks can result from management error, divorce, death, illness or injury (temporary or permanent), and temporary leave (military, family, or other).

Formalized contingency planning and efficient management can improve business performance and minimize damages when your business has an interrupting event. Benefits of contingency planning can include: allowing you to focus on the right proprieties in your family and business, allowing the business to function during the illness or absence of a key person, and giving employees a better opportunity to plan their own lives.

What is a contingency plan? A business contingency plan is a set of procedures that defines how a business will continue or recover its critical functions in the event of an unplanned disruption to normal activities. No other process does a better job of making a business assess its operations and processes. It's a structured exercise of planning what to do when key operations are not available. The following components are included in a contingency plan:

1. Risk Assessment. The risk assessment component of plan allows businesses to identify and exclude activities in the business that expose the business to unacceptable risk. The risk assessment increases the likelihood that you will select the best possible combination of risk management strategies.

2. Business Impact Analysis. During this step of contingency planning, you analyze the impact that events could have on your business in terms of operating impact (loss of the business or operating efficiency), financial impact (loss of customers, business credit rating, increased cost of temporary help, or cash flow problems), and legal impact (unfulfilled contracts with suppliers, customers, and/or vendors). During this phase, you need to identify the critical functions within the business to fully analyze business impact. For any event that you can see occurring in your business, consider both probability and consequences so that you can decide which strategy to use.

3. Risk Management Strategies and Tools. Be sure to document procedures for handling an incident (i.e. who performs what critical business functions). You should have a checklist for employees that details the procedures for each critical business function and for handling financial issues. There are four main strategies for dealing with risk:

    - **Risk avoidance** requires a business to take actions to evade risky situations.

    - **Risk reduction** includes businesses taking actions that build an extra degree of safety into a situation with an identified level of risk.

- **Risk anticipation** (retain the risk) promotes self-insurance.
- **Risk transfer** depends on the use of insurance.

4. Risk Management Goals. Goals provide targets to aim for and provide a basis for evaluating business performance. Be sure to involved family and key employees in the planning process to create a sense of group ownership in the business goals.
5. Document the Plan. Write down the plan, share it with family and employees, and update it annually.

Contingency planning may initially seem like a large ask in terms of focused time, but when (not if) your business experiences a disruption, you will be glad that you have your plan.

Special Succession Edition

We hope that you enjoyed reading our special edition on succession. Succession has been and continues to be a very important issue for farms and family businesses. A special team of Extension and educators make up the Purdue Extension Succession Planning Team. All of the articles included in this newsletter are written by our team and inspired by our recent webinar series “Keeping the Farm Resilient in Uncertain Times”.

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The Succession Planning Team

The PIFB team of Maria Marshall and Renee Wiatt have filmed videos to kick off the *Family Business Video Series.* The first two videos in the series are linked below. Continue to stay engaged with our Institute and our YouTube Channel as we release more videos.

- What is a Family Business?

  This video will explain how to define a family business, how families influence firms, and the amount of control that families can have in their businesses. Also, the three systems of ownership, family and business and their intersection is explained.

- Social Structure of the Family

  This video dives into the social structure of the family business, including family of orientation and family of procreation. The structure of the family can ultimately affect how the business is run, passed down to the next generation, and how decisions are made.

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